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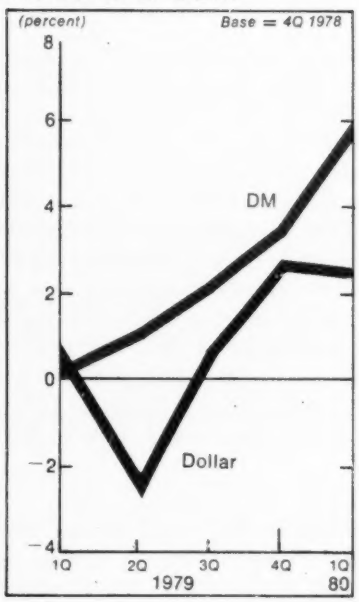
Sustained Franc Strength A Strong Possibility

The phenomenon of the strong French franc has perplexed foreign-exchange analysts for well over a year now. Despite a French economic performance that is far from inspiring, the franc stands firmly at the head of the European Monetary System, a position it has occupied since March.

Several indicators that serve as traditional barometers of a currency's future movement have persistently pointed in a downward direction. First, inflation in the first quarter averaged 16.2%, annualized, and is now rising at a year-over-year 14%. Second, the current account has shifted into substantial deficit after two years of surplus, with the deficit for the first quarter of the year estimated at 10 billion francs. Third, monetary growth continues strong, buoyed by high credit demand. The Government's objective of reducing M_2 growth from its current annual rate of 13% to 11% by yearend is likely to prove difficult to achieve. Despite these adverse elements, however, the franc has held firm.

Real appreciation of the franc against the dollar and DM



Two factors appear particularly instrumental in buoying the French currency. The first is the fundamental shift in government policy associated with Prime Minister Raymond Barre. Barre has repeatedly espoused a program of austerity combined with liberal reforms. The Government has set restrictive monetary targets, has tightened credit controls progressively, and is determined to trim the budget deficit. Moreover, Barre has continually emphasized the central role that a firm exchange rate plays in French economic policy. Another factor favorable to the franc has been the relative weakness of the German mark. The mark's softness reflects a large current-account gap associated with Germany's recently buoyant economic growth.

Whether the franc will remain a leading European currency in the second half of 1980 is a matter of some speculation. As the French economy moves into recession and unemployment increases, political pressure to reflate will mount. And given the outlook of no imminent change in German monetary policy, an easing of French interest rates would seriously undermine international confidence in the franc. Still, there are several major constraints to any relaxation of the present strong-franc policy. The chief factor is the approaching presidential election scheduled for next spring. As long as the fight against inflation remains a critical economic and political objective, the authorities are unlikely to risk any currency devaluation. And without a general realignment of EMS parities, French monetary policy will very likely be kept on its present course, thereby limiting the scope for any lowering of interest rates by yearend and pointing to a continuation of a firm franc exchange rate.

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German economy signaling a downturn.

The German economy is beginning to show signs of weakening, after a strong first quarter in which industrial output rose at a seasonally adjusted annual rate of 6.4% over fourth-quarter 1979. Provisional figures reveal that industrial production fell 1.6% in April, with industrial order volume declining 4.5%. The drop in orders was broadly based across industries, but not across markets—the value of domestic orders fell a real 7%, while foreign orders declined by only 1%. The weakening of domestic demand has been confirmed by a recent survey that reveals a sharp deterioration in the business climate. And although another recent survey of investment intentions suggests a 10% *rise* in the volume of manufacturing investment this year, experience has taught that intentions are not always an accurate forecaster of realized investment. With German inflation—now 6% year-over-year—eroding consumers' real incomes, a further weakening of consumer spending is expected. And if foreign demand turns down in late 1980, the currently high level of inventories would create serious problems for industry and contribute to a pronounced cyclical downturn in the economy in the latter part of the year.

Weak Spanish economy reflected in a declining peseta.

Spain's current economic problems of rising unemployment, continuing inflation, and a deteriorating balance of payments have created problems for the center-right coalition Government of Adolfo Suarez. It recently survived a no-confidence vote in Parliament by only a narrow margin. A televised debate highlighted the country's problems, but no economic policy changes have been announced, nor are any expected to be. Monetary policy remains accommodating, despite rumors of renewed tightening in view of large budget deficits in the first few months of 1980. (Improved income tax receipts and an easing of private-sector credit demand, however, reportedly led to reduced monetary growth in April.) The peseta's exchange value has declined steadily since May 1979; it is expected to continue to decline moderately throughout 1980 as oil prices rise further and because tourist revenues are likely to be weak this season. Nevertheless, little currency intervention is expected by the Bank of Spain. Meanwhile, French opposition to Spanish membership in the European Community could postpone Spain's entry date beyond the presently scheduled early-1983.

Irish trade balance improves, but at a high cost.

Ireland's 1980 budget, introduced in February, reduced public expenditure and increased taxes largely to contain the country's widening trade deficit. The budget achieved its objective to some extent, for the trade deficit has narrowed steadily from January's huge gap of 204 million Irish pounds to £95 million in April. But the improvement in the trade balance still leaves the country with a deficit of 560 million pounds for the first four months of the year, versus £482 million for the same period in 1979 and 234 million pounds for January-April 1978. In addition, the deflationary impact of the budget is becoming clearer; most forecasters see less than 1% GDP growth for 1980. Unemployment has risen steeply, reaching its highest level at end-May since the winter of 1978—slightly over 9%. Tax increases have pushed up the cost of living, and the February consumer price index stood at 15½% above its year-earlier level, with the May figure expected to approach 20%. Thus, the country faces a long and difficult period of economic adjustment before any return to the rapid growth of the 1970s can be achieved.

Indonesian economic outlook uniquely bright.

The economic outlook for Indonesia is far brighter than most in the world. Rapidly rising oil and gas revenues, favorable world prices for tin, rubber, and lumber exports, and a burgeoning manufacturing export sector tied to cement, textiles, and electronics will give Indonesia a balance-of-payments surplus of over $2 billion for the current fiscal year ending March 1981. Overall, real GNP growth is expected to be a strong 7%. The country's foreign-exchange reserves, less than $600 million in 1975, will probably exceed $6.5 billion this fiscal year, an improve-

ment of more than tenfold in just five years. Given the bullish world price outlook for oil and domestic production projections, substantial payments surpluses appear virtually certain, at least through the first half of the 1980s. Accordingly, financial indicators such as the debt-service ratio should continue to improve markedly. Indonesia is now exploring ways of stepping up expenditures to speed up the pace of economic development, and is expected to take advantage of its favorable international credit standing to obtain additional loans and spur foreign investment. Indonesia's goal is to broaden its industrial base, mainly in primary commodities processing, and thereby improve its long-term payments outlook.

Japanese inflation to ease toward yearend.

The year-over-year increase in Japanese consumer price inflation reached 8.4% in April, compared with an average rate of 3.6% in 1979. The roots of the present inflation lie in the expansionary monetary policy pursued in late 1978 and early 1979, combined with the sharp rise in import prices—mainly of oil and raw materials. As the 21.1% increase in wholesale prices in the first quarter implies, the consumer inflation rate is likely to climb into double digits for a brief period this summer before it begins to decline later in the year. While Japanese consumer price increases reflect some of the rise in wholesale prices, the recent slowing of the monetary aggregates, weakening consumer demand, stabilization of import prices, conservative wage increases, and productivity gains should work to moderate the rise in consumer prices. Moreover, the present commitment to anti-inflationary policies is not expected to change significantly following the June 22 elections and the installation of a new government.

Yugoslav political succession complete; attention now focused on economic adjustment.

Yugoslavia's political leaders have managed the post-Tito succession process with considerable skill. They have also begun to address the country's serious economic problems of excessive investment spending, high inflation, and a large balance-of-payments deficit. The Yugoslav domestic inflation rate has exceeded 25% since early 1979, while the balance-of-payments gap widened to $3.7 billion last year. In response to these problems, the National Bank of Yugoslavia announced a 30% devaluation in the second week of June, setting a new exchange level of 27.30 dinars to the U.S. dollar. After the appropriate rise in the prices of imported commodities, domestic prices will be frozen for a short period. Moreover, earlier in the year, major restrictions were imposed on the growth of personal incomes, enterprise credit, and capital investment. Western commercial banks continue to be an important source of liquidity. Net indebtedness to Western banks increased $2.7 billion last year, reaching a level of $5.5 billion at yearend; additional commercial borrowing is expected in 1980 as the adjustment process proceeds. In support of the Yugoslav economic stabilization program, the IMF has approved a standby arrangement that authorizes drawings of up to $430 million during 1980 and 1981.

Energy export revenues underpin Algerian economic improvement.

The sharp rise in oil prices since mid-1979 has led to a significant turnaround in Algeria's economy. The country's current account was in balance last year after posting a $3.5-billion deficit in 1978, and estimates for 1980 suggest a surplus of about $1.5 billion. The surge in export revenues—projected to total $14 billion this year—reduced 1979 Eurodollar borrowings by about one-third from their 1978 level, and have trimmed the debt-service ratio from 25% in 1978 to 22%. The likelihood of continued strong energy export earnings remains high, especially with Algeria being hawkish on price boosts. Prior to the recent OPEC meeting in Algiers, Algerian crude fetched $38.21 per barrel (including a $3 exploration surcharge), the highest in OPEC. Moreover, gas shipments to the United States and France have virtually ceased while efforts are made to more than double gas prices to align them with those for oil. The increased revenues will be channeled in a somewhat different manner. The country's new president has altered the direction of development policy by de-emphasizing heavy industry and giving greater priority to agricultural and social investment.

The High Cost of U.S. Oil Policy Failure

Two recent events underscore the problems faced by the United States in overcoming its excessive dependence on imported oil. First, Congress rescinded President Carter's authority to impose an oil-import fee and overrode his subsequent veto. Second, the Organization of Petroleum Exporting Countries implemented additional price increases, despite high inventories of crude oil and refined products in the United States and elsewhere. The latest boost in oil import prices—the average per barrel cost to refiners of imported crude is now about $35, versus $15 at the beginning of 1979—will contribute to doubling the U.S. import bill to $85 billion this year from $42 billion in 1978.

As recently as 1969, only 25% of the United States' total oil supply was imported. Last year, by contrast, oil imports accounted for 45% of supply. But contrary to the notion that it is the monopoly power of OPEC that has led to this increased dependence, it could not have occurred without a series of U.S. Government actions that played directly into the hands of OPEC.

A heightened concern about U.S. dependence on foreign oil occurred in two earlier periods. In the early 1920s, imports accounted for about 20% of total crude supply. However, rapidly rising domestic production during the rest of the decade reduced dependence to about 10%. From 1930 to 1946, imports averaged about 6½% of crude supply. But the energy needs of a growing post-war economy outstripped the domestic oil industry's capacity to increase production. By 1957, the import share had climbed to 18%, leading then-President Eisenhower to exhort importers to voluntarily limit the quantity of foreign crude. The appeal for voluntary restraint failed, however, and a mandatory oil-import quota program that restricted the market share of imported oil was instituted in 1959.

Rapid economic growth in the 1960s led to sharp increases in the quantity of oil demanded, which was largely satisfied by an increase of nearly 30% in domestic production. But rising domestic output also allowed the volume of imports to increase equally rapidly—so long as it maintained a fairly constant market share of 12%-15%. Moreover, imports of exempted refined products grew even more rapidly.

The low cost of foreign oil served to limit domestic prices. The wholesale price of domestic crude oil declined by 5% relative to other industrial commodities between 1959 and 1969, and the relative retail price of refined petroleum products such as gasoline dropped 7½% over the same period.

The falling real price of oil and refined products dampened U.S. oil producers' incentive to explore for new sources. The number of wells drilled declined by 40% between 1959 and 1969. As a result, new additions to proven oil reserves fell below the level of domestic production. Proven domestic reserves in

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1979		BALANCE			
		3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered
Argentina	First-quarter real GDP growth was 3.6%, annualized, paced by construction and investment activity.	Mar.	+ 32%	102.1	$3,825	Feb.	9,730	+ 78%	24.9
Bahamas	Higher oil costs and aggregate demand pressures boosting the price level.	Dec.	+ 18%	1.0	4,000	Apr.	102	0	2.1
Brazil	Inflation rate reaches record 95% in May; Government continues efforts at price stabilization.	Apr.	+ 31%	209.1	1,760	Feb.	7,703	− 32%	4.5
Chile	Price controls lifted on several items; inflation in first quarter roughly the same as in 1979.	Feb.	+ 70%	19.0	1,710	Apr.	2,277	+ 51%	6.5
Colombia	Major effort under way to develop domestic energy resources; coal and natural gas show most promise.	Apr.	+ 44%	28.7	1,100	Apr.	4,121	+ 57%	10.8
Costa Rica	Economic slowdown expected in view of more restrictive fiscal and monetary policies.	Jan.	+ 20%	3.9	1,790	Apr.	81	− 50%	0.7
Ecuador	Potential conflict between President and Congress resolved for the time being.	Apr.	+ 45%	8.7	1,070	Apr.	830	+ 23%	5.2
El Salvador	Political upheaval having severe repercussions on domestic economic activity.	Dec.	+ 3%	3.4	760	Apr.	102	− 64%	1.2
Guatemala	Central bank provides emergency $60-million line of credit to financially strapped private sector.	Dec.	+ 9%	7.2	1,060	Apr.	654	− 20%	5.5
Guyana	Rice, sugar, and bauxite output rates recovering from strike-induced declines of last year.	Dec.	− 2%	0.5	625	Dec.	9	− 84%	0.3
Honduras	Economic expansion continues brisk; opposition party wins majority votes in assembly elections.	Sept.	+ 34%	1.9	540	Jan.	208	+ 14%	3.3
Jamaica	Massive, five-year expansion plan announced for bauxite/alumina industry; alumina output up 7%.	Nov.	+ 4%	2.7	1,230	Mar.	89	+ 16%	1.1
Mexico	Investment spending and employment gaining strongly, but inflationary pressures also intensifying.	Jan.	+ 52%	117.9	1,700	Jan.	2,218	+ 13%	2.2
Nicaragua	Economic recovery proceeding slowly; reconstruction effort hindered by insufficient financing.	Oct.	− 52%	1.7	660	Nov.	85	+ 42%	2.9
Panama	Government making progress toward limiting fiscal deficit through spending curbs and taxing effort.	Dec.	+ 71%	2.7	1,420	Mar.	90	− 55%	1.0
Peru	Increased activity in mining, oil, and manufacturing may boost economic growth to 5% this year.	Dec.	+129%	12.1	700	Mar.	1,510	+274%	12.0
Uruguay	Standby program with IMF aimed at slowing inflation and further liberalizing foreign trade.	Dec.	0	7.2	2,500	Feb.	441	+ 18%	4.5
Venezuela	Economy continues depressed; auto and cement sales down 17% and 6%, respectively, in first quarter.	Jan.	+ 56%	46.1	3,385	Mar.	6,296	+ 21%	6.7

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absolute terms dropped by almost 7% between 1959 and 1969, constraining subsequent output further.

The rise in the foreign share of U.S. oil supply from 18% to 25% between 1959 and 1969, and the concomitant decline in domestic reserves, should have brought forth effective Federal policies to encourage conservation and domestic exploration. This could have been accomplished through higher prices and/or more severe restrictions on imports, perhaps via the auction of import licenses. Unfortunately, however, no such steps were taken.

As the quantity of oil demanded continued to grow in the early 1970s, while domestic production declined, the U.S. Government permitted oil imports to skyrocket to 40% of supply. And relative prices of crude oil and oil products were allowed to fall further, albeit at a slowing rate. The United States was suddenly struck with the high price of its dependence in the winter of 1973-74, when a partial OPEC embargo and the quadrupling of imported oil prices aggravated inflation and the recession then under way.

The U.S. adjustment to higher oil prices then began. It was however, hampered by price controls on domestic crude oil and gasoline. Nonetheless, conservation efforts launched then were successful in slowing the growth rate of energy use relative to total economic growth. But since domestic oil production has shown virtually *no* increase in the last five years, whatever economic growth that has occurred has resulted in further deterioration in the import ratio. By 1977-78, imported oil accounted for about 50% of supply. Shortly thereafter, in 1979-80, the U.S. economy was dealt another blow as OPEC prices were boosted sharply.

In contrast to the counterproductive policy of price controls following the 1973-74 round of OPEC price rises, however, the sharp increases in early 1979 were accompanied by the start of a phased decontrol of U.S. crude oil and gasoline prices. Consumption then began responding to higher prices. Gasoline demand is now about 10% lower than a year ago, and oil imports currently constitute "only" 41% of supply.

Yet one cannot but wonder how the decade of the 1970s might have looked if the United States had launched a more responsible oil policy sooner, and indeed a more effective overall energy policy. The U.S. remains saddled with a high level of imports and high prices. Had the country accepted higher prices sooner, imports would certainly have been lower, and the pricing power of OPEC might have been significantly reduced.

The United States consumes about one-third of the non-Communist oil supply. Consequently, U.S. consumption has a disproportionate impact on world prices, so U.S. responsibility to formulate effective policy is substantial. Some of this responsibility will be discharged when U.S. crude oil prices reach world levels in September 1981, but oil products will still be much cheaper than elsewhere because of lower taxes. Thus, stronger U.S. measures to bring domestic supply and demand into better balance are critical if price hikes are to be curbed in the future. *Douglas L. Bendt*

F PAYMENTS		MONEY AND BANKING							COUNTRIES
s of IMF dit, mil- of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate June 18, 1980	exchange rate in U.S. dollars June 18, 1980	current monetary conditions	
0	Rapid import growth produces first-quarter trade deficit.	May	+115%	Jan.	+160%	—	.00060	Short-term interest rates rise.	Argentina
0	Tourism sector shows strong earnings.	Feb.	+ 12%	Dec.	+ 7%	—	1.01	Bahamian dollars limited in availability.	Bahamas
0	Small trade surplus posted in May.	May	+ 95%	Mar.	+ 69%	33.00%	.0205	New tax boosts cruzeiro borrowing costs.	Brazil
50	Ban on foreign-currency loans lifted; limit on banks' external debt removed.	Apr.	+ 39%	Aug.	+ 48%	—	.0270	Rapid growth in banks' net international assets.	Chile
0	Higher coffee prices boost export earnings.	Feb.	+ 26%	Apr.	+ 21%	30.00%	.0240	Money restraints eased somewhat.	Colombia
74	External payments position remains weak.	Jan.	+ 15%	Jan.	+ 40%	8.00%	.1200	Credit growth curbed.	Costa Rica
0	Larger trade surplus posted, owing to oil exports.	Mar.	+ 13%	Nov.	+ 43%	8.00%	.0370	Some restrictions placed on domestic lending.	Ecuador
0	Exports not likely to drop much from 1978 level.	Aug.	+ 7%	Jan.	+ 31%	—	.4030	New credit lines opened to export producers.	El Salvador
0	Foreign-exchange controls imposed; profit remittances abroad not affected.	Mar.	+ 11%	Jan.	+ 28%	—	Par	Liquidity is tight.	Guatemala
57	Higher oil prices boost import costs.	Dec.	+ 18%	Dec.	+ 27%	10.50%	.4000	Bank reserves decline.	Guyana
21	Banana exports should reach $200 million in 1980.	Sept.	+ 9%	Jan.	+ 14%	4.00%	.5010	Lending rates increased.	Honduras
43	Banks agree to month-to-month deferral of principal repayment on debt.	Dec.	+ 18%	Jan.	+ 22%	11.00%	.5800	Further decline in net international assets.	Jamaica
87	Oil export markets being diversified.	Feb.	+ 23%	Dec.	+ 31%	4.50%	.0450	Higher interest rates attract increased deposits.	Mexico
56	Debt rescheduling negotiations with commercial banks continue.	Dec.	+ 63%	Aug.	+ 56%	—	n.a.	Net international reserves are low.	Nicaragua
38	Large increase in Colon Free Zone earnings.	Feb.	+ 14%	Dec.	+ 23%	—	Par	Rapid growth of banking sector.	Panama
04	Surcharge on imports annulled; licensing need for certain items abolished.	Mar.	+ 60%	Oct.	+ 29%	29.50%	.0040	Increase in short-term rates.	Peru
0	Tourism earnings rise sharply.	Mar.	+ 78%	Dec.	+110%	—	.1175	Heavy inflows of external funds into banks.	Uruguay
0	Import demand weak during first half, while export earnings continued rising.	Mar.	+ 22%	Jan.	+ 5%	12.00%	.2335	Net international reserves rising.	Venezuela

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World Interest Rates

market rates of June 18, 1980; bond yields as of June 13, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	11.00	11.29	17.00	14.00	9.50	7.50	15.00 penalty rate 18.00	10.00	3.00	9.00
Day-to-Day Money	9.375 June 19	15.00	15.75	12.40	12.875	10.10	16.875	11.00	5.50	12.6875
Treasury Bills 91-day, Middle Rates	6.86	10.50	15.5625	14.50	n. a.	n. a.	14.60 73-day	no dealing	no market	6.75 2-month
Commercial Paper prime, 3-month, asked	7.50 finance paper	11.10 finance paper 15% tax w/h	14.44	13.90 Certified	12.50 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.00	11.00 15% tax w/h	15.75	14.50 Certified	not traded	9.90	19.00	no market	4.50 not traded	no market
Government Bonds Long-term, new and old issues, average yield	9.49	11.31	13.58	10.38 20% tax w/h	12.96	8.15	15.14	9.93	4.77	8.09
Industrial Bonds prime, long-term, new and old issues, average yield	10.75 Aa Industrials	11.90	14.27	14.11	13.86	8.29	15.15	10.77	5.70	7.40
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	13.75	18.00	18.25	14.60	11.50	20.00	13.00	5.50	9.25
Bank Time Deposits 3-month	7.875 Cert. of Dep.	11.00 Cert. of Dep.	16.50	14.05	12.5625	9.85	10.75	10.75 large deposits	5.50 residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	9.00	no market	16.75	no market	12.625	9.3125	no market	10.5625	5.5625	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8682	2.3290	.03542	.2435	.5672	.001199	.5175	.6161	.004638
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.27 *P*	7.55 *D*	5.18 *D*	3.75 *D*	.35 *D*	10.26 *D*	1.70 *D*	2.85 *D*	1.12 *P*

Eurodollar Deposits
(London, interbank, bid)
June 19

7-day	8.9375
1-month	9.125
3-month	9.25
6-month	9.3125

International Arbitrage
(3-month, hedged) *+ in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	— .94
U.S.-Canada Treasury Bills	—6.50
U.S.-Canada Finance Co. Paper	—6.72
Eurodollars-U.K. Local Auth. Deposits	— .20

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	10.50
Over 7 yrs.	11.00
DM Bonds	
7 yrs. and under	8.25
Over 7 yrs.	8.25

Gold Price

London afternoon fixing

602.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Current economic indicators of major industrial countries

	U.S.	Canada	Britain	France	Germany	Italy	Switzerland	Japan
Consumer prices*	14.7 (Apr.)	9.4 (May)	21.9 (May)	13.9 (Apr.)	6.1 (May)	20.7 (Mar.)	4.3 (May)	8.4 (Apr.)
Industrial production*	—4.7 (May)	—1.3 (Mar.)	—4.8 (Apr.)	4.6 (Apr.)	4.1 (Apr.)	14.9 (Apr.)	4.0 (Dec.)	10.0 (Apr.)
Trade balance† *(billions of local currency units)*	—$1.87 (Apr.)	—C$.007 (Apr.)	—£.018 (May)	—FF7.75 (May)	DM1.1 (Apr.)	—Lit.1,510 (Apr.)	—SF1.26 (Apr.)	—¥490 (Apr.)
Money supply (M_1)*	4.1 (May)	6.1 (Apr.)	2.5 (Apr.)	8.7 (Feb.)	—1.1 (Feb.)	22.4 (Nov.)	—14.8 (Mar.)	7.0 (Mar.)
Velocity of money (M_1)*	2.7 (Mar.)	12.2 (Dec.)	4.8 (Sept.)	11.1 (Sept.)	4.1 (Dec.)	—0.2 (Sept.)	n. a.	3.8 (Dec.)
Reserves minus gold *($ million, change from previous month)*	74 (Apr.)	274 (Apr.)	1,833 (Apr.)	4,334 (Apr.)	1,938 (Apr.)	3,629 (Apr.)	—645 (Apr.)	3,629 (Apr.)

* Percent change from 12 months earlier.

† Figures are only for the month indicated.

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New Legislation Challenges Banks

The following is based on a recent speech given by **Richard C. Aspinwall,** *Vice President and Director of Banking and Financial Market Research, the Economics Group of The Chase Manhattan Bank, before the Bank Marketing Association.*

The new banking legislation enacted in March points to major changes in bank markets. The main issue is not whether change will occur, or even when, but how much. The bill—the Depository Institutions Deregulation and Monetary Control Act (the "omnibus" banking bill)—significantly broadens the asset and liability powers of thrift institutions. It also creates a vehicle for eliminating certain deposit ceiling rates; authorizes consumer NOW accounts for all banks and thrifts; and provides new schedules of reserve requirements for most depository institutions. The adjustments that these changes portend for banks are coming at a time when bank intermediation generally is being subjected both to greater risks from the effects of inflation and to increased pressures on profit margins stemming from a wide variety of competitive forces.

Overview of banking legislation and regulation

I shall turn to specific banking implications of the new omnibus bill shortly. But first it is useful to delineate some general themes relating to banking legislation and regulation.

First, responses to changes in economic and financial conditions constitute the major dynamic forces that shape strategies of bank management. Here are several examples of recent changes in conditions: (1) higher and more variable inflation; (2) higher and more volatile rates of interest; (3) rising reliance by business and individuals on debt to sustain spending; and (4) the greater institutionalization of saving (e.g., through pension and profit-sharing arrangements).

These factors have been reflected in a variety of changes in banking practices. First, bank customers are exercising tighter control over their liquid assets. Second, banks are resorting more to funding liabilities on which market-based interest rates are paid. For example, the share of bank assets represented by such liabilities rose from 18% in 1972 to almost 40% in 1979. Third, there is a strong tendency (e.g., in mortgage lending) to seek closer linkage between returns on loans and funding costs. Fourth, nondeposit entities are becoming more aggressive in a number of banking functions, especially those where regulatory restrictions have imposed major constraints on banks' operating efficiency. Expanded business reliance on the commercial paper market is one such example. Finally, thrift institutions have responded to some of these same dynamic forces by broadening their range of financial services.

My second point is that changes in banking legislation and regulation tend to be lagging, not leading, influences. They validate or legitimize, but do not normally innovate (except inadvertently). The NOW account development, which began in New England, is a good example.

My third point is that, as a reform measure, the new banking bill is seriously deficient in several respects. Its deficiencies are likely to impose continuing problems for banks (and other depository institutions) and their customers. First, the bill does not provide for the elimination of the prohibition against interest on demand deposits. This prohibition has encouraged a wide variety of operating inefficiencies. It has also contributed to inadequacies in the machinery of monetary control. Nor does the legislation fully eliminate usury ceilings. Second, there is no provision for removing present constraints on interstate expansion by branches or holding-company affiliate banks. Third, important restrictions now imposed under Glass Steagall—for example, those aimed at commingled investment accounts—are not addressed.

And finally, despite the Congressional provision that Regulation Q be eliminated over the next six years, such an outcome is highly uncertain. To be specific, the new banking bill vests authority to set deposit interest rates with a Deregulation Committee. For one thing, the Committee may feel its latitude is constrained by the fact that old, low-yielding, fixed-rate mortgages will impose a drag on earnings for some time to come. Moreover, Congress has not directly addressed the issue of ceiling differentials between banks and thrifts. Differentials could remain in force as long there are ceilings per se. Politically, this may serve to sustain ceilings. And furthermore, the Committee has not been especially aggressive in providing for deregulation so far. For example, it has embraced *new* restrictions on premiums as promotional devices, finders fees, and early withdrawal penalties. In short, those anticipating a Q-free environment six years from now had better hedge their bets.

Banking implications of the omnibus banking bill

Given the dynamic influences affecting financial markets, here are the major banking implications that I believe stem from the omnibus bill:

1. *Thrift Competition.* The bill authorizes interest-bearing personal checking accounts on a nationwide basis for banks and thrifts. In addition, it provides

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that Federal savings and loan associations may invest up to 20% of their assets in a combination of consumer loans, commercial paper, and corporate debt securities. While it may appear small, the 20% maximum seems to offer ample latitude for vigorous entry by those institutions finding these markets attractive. Indeed, as a starting point, the 20% figure is not substantially out of line with many *banks'* present positions. For all commercial banks (as of December 1978), commercial and industrial loans were only 17½% of their total assets and consumer credit was less than 15%. For the largest banks (assets of $5 billion or more), the proportions were about 22% and 8%, respectively.

So as a means of strengthening their positions as sources of individuals' financial services, it seems highly likely that thrift institutions will seek to expand aggressively into transactions services and consumer credit. And they will also look to some business lending. In connection with product extension, however, there is some question about the means thrifts will employ to expand retail presence. Even if desired, an enhanced branching network cannot be established quickly (e.g., it takes time to build and staff branches, and many good sites are already taken). Methods to counter short-run network handicaps will include emphasis on remote transacting facilities, aggressive pricing and promotion, more liberal terms of service (including credit terms), and product innovation. Such efforts clearly point to the prospect that this new competition will speed the obsolescence of traditional bricks-and-mortar branching. And the institutional population itself is likely to undergo significant change.

2. *Deposit Pricing.* As I have already suggested, it is far from certain that Regulation Q will be effectively eliminated within six years. Assuming market interest rates fall toward (and possibly below) ceilings on a reasonably wide scale during the next year, the acid test of the Deregulation Committee's resolve is near at hand. Provision for ceiling elimination is most easily accomplished when existing ceilings are not binding. Later on, when market rates again rise well above whatever ceiling levels remain, strong political pressures against substantive action are likely to develop. Failure to eliminate ceilings will mean that an increasing share of retail financial services will move outside depository institutions in the future. Unregulated alternatives are readily available.

Assuming the Regulation Q phase-out proceeds, banks will have to apply more rigorous techniques of asset and liability management to retail funding. This will be more of a learning process for smaller banks than larger ones. In the past, retail deposit pricing was largely (although not entirely) a function of applicable Regulation Q ceilings.

3. *Reserve Requirements and Related Matters.* The omnibus bill establishes an 8%-14% range (with 12% the initial rate) for reserve requirements on all transactions accounts totaling over $25 million at banks and other depository institutions. Reserve requirements on personal time deposits are eliminated. And a range of 0-9% (initially 3%) is established for nonpersonal time deposits. The new bill also requires the explicit pricing of Federal Reserve operating services, including the value of float, and this action is likely to encourage more efficient operating practices.

In terms of marketing strategies, what must be emphasized is that reserve requirements such as these are a tax. The opportunity cost represented by these reserves is a cost to banks and ultimately to their customers. It is not a tax that is imposed on nondeposit institutions. Consequently, it entails a competitive disadvantage for those subjected. It will thus ensure that further amounts of banks' business may shift to those entities and transactions not subject to the tax. Indeed, under this legislation, deposit institutions are exposed to the risk of becoming chiefly switching points for transfers of liquid assets that are increasingly outside the deposit system. As with demand deposits generally, the payment of explicit interest on reserve balances would largely eliminate the inefficient and disruptive efforts encouraged by the reserve-requirement tax.

Conclusion

In a narrow sense, the initial competitive impacts of the omnibus bill will tend to be more oriented to "retail", rather than "wholesale", banking. The former has been more heavily regulated, of course. But over the longer run, all banking markets face substantial changes in pricing, delivery of services, and numbers of competing institutions.

The new competition encouraged by this legislation will be only one aspect, however, of dynamic change in markets for financial services. More forceful participation by nondeposit entities is also an increasingly potent force. But in the final analysis, the greatest unknown will be the effects of future economic conditions on intermediation. As we have seen, more volatile economic conditions have meant increasing financing risks and uncertainties. These greater risks and uncertainties must be contained or serious problems—and possibly disruptions—lie ahead in the 1980s.